Chinese Buying Could Render Taper Moot

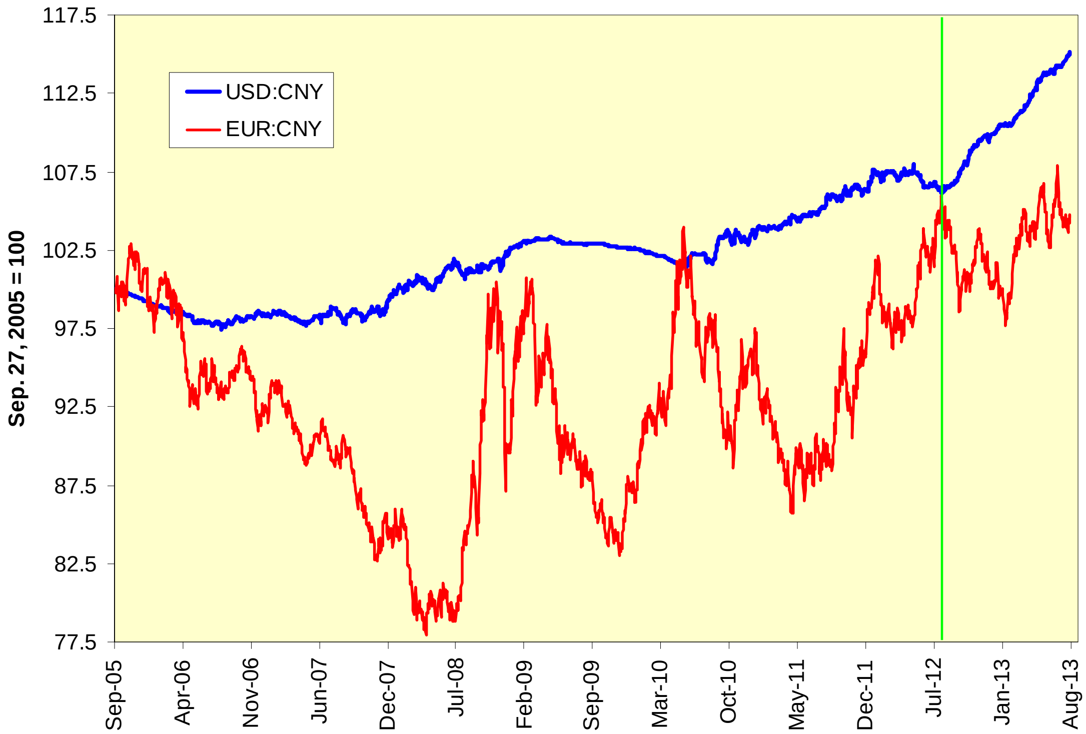
It is somewhat unfortunate the characterization of something as "kabuki" originated from the eponymous Japanese theater style; otherwise, it could have been originated to describe the multiparty currency dance between the U.S., the Eurozone, China and Japan over the past five years.

I noticed this first after the yuan revaluation stopped cold in its tracks after the July 2008 backstopping of Fannie Mae and Freddie Mac. Chinese officials were stunned to learn their holdings of the mortgage giants did not carry the full faith and credit of the Treasury. A deal was struck, apparently, to backstop these holdings in exchange for an end of revaluation. Other deals have come and gone involving a tradeoff between Federal Reserve quantitative easing and Chinese purchases: They will support our debt in exchange for an end to revaluation when the Federal Reserve ceases to finance the Treasury. Of course, the Federal Reserve has found it difficult to stop talking monetarily and let someone else get a word in edgewise.

Switch From Euro

If the FOMC decides to start tapering its purchases in September, something it almost has to do given the lower issuance of Treasuries and generation of mortgage-backed securities regardless of the macroeconomic data, China could switch from supporting the euro as it has since Mario Draghi's July 2012 "whatever it takes" declaration. This is not a far-fetched notion at all: If we map the excess carry returns from borrowing the dollar and euro and lending into the yuan, we see a strong break at the end of July 2012. The yuan started to strengthen against the dollar but actually has weakened against the euro. Implied here has been Chinese support of Europe's bedraggled sovereign debtors.

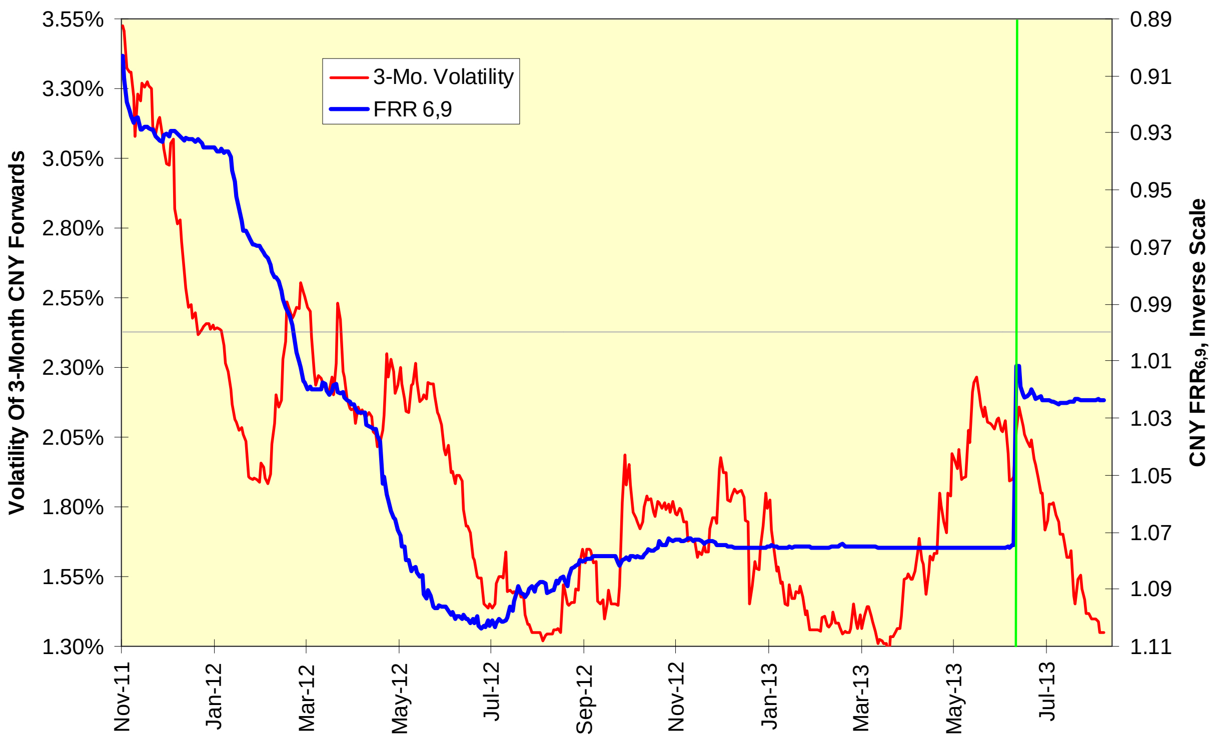
Comparative Carries Into Yuan



Response To FOMC Backtracking

Next, let's take a look at how the volatility of three-month yuan forwards collapsed after the June 24th mea culpas from FOMC officials about ending QE. The sharp decline in volatility suggests a great deal of acceptance of its accelerated rise. Once again, the implied deal was the Federal Reserve would keep on supporting China's portfolio investment, per 2008, but this time the U.S. would use its debtor leverage to have China keep revaluing the yuan. Please note how abruptly interbank lending conditions in Shanghai changed on this date; the yield curve as measured by the forward rate ratio between six and nine months flattened immediately as a way of boosting the yuan.

Yuan Money Market Yield Flattened After FOMC's July Backtracking



The stage is now set: If the Federal Reserve starts its taper at last and China's portfolio holdings are threatened, China can step into the breach and start buying Treasuries instead of various Eurozone bonds. The euro will weaken, the dollar will stop declining against the yuan and the net effect of the taper on U.S. financial markets will be cushioned.